Office of Chief Counsel Internal Revenue Service

# memorandum

CC:WR:SCA:SD:TL-N-2381-00 YMPeters

date:

MAY 31 2000

to:

Brian Bomar, Team Coordinator

CE 1104, San Marcos

from:

Associate District Counsel, Southern California District, San Diego

subject:

- TLN 2381-00

Tax Treatment of Corporate Takeover Defense Costs

#### **DISCLOSURE LIMITATIONS**

This advice constitutes return information subject to I.R.C. § 6103. This advice contains confidential information subject to the attorney-client and deliberative process privileges and, if prepared in contemplation of litigation, subject to the attorney work product privilege. Accordingly, the recipient of this document may provide it only to those persons whose official tax administration duties with respect to this case require such disclosure. In no event may this document be provided to persons beyond those specifically indicated in this statement or to taxpayers or their representatives.

This advice is not binding on the Internal Revenue Service and is not a final case determination. Such advice is advisory and does not resolve Service position on an issue or provide the basis for closing a case. The determination of the Service in the case is to be made through the exercise of the independent judgment of the office with jurisdiction over the case.

This memo responds to your memorandum dated April 12, 2000, regarding the tax treatment of expenditures incurred in creating a "poison pill" as well as other expenditures paid to reduce so vulnerability to a possible, but not yet threatened, hostile (inadequate) takeover.

## **ISSUES**

Whether the costs associated with the second second is adoption of a shareholder rights plan should be capitalized.

#### **CONCLUSIONS**

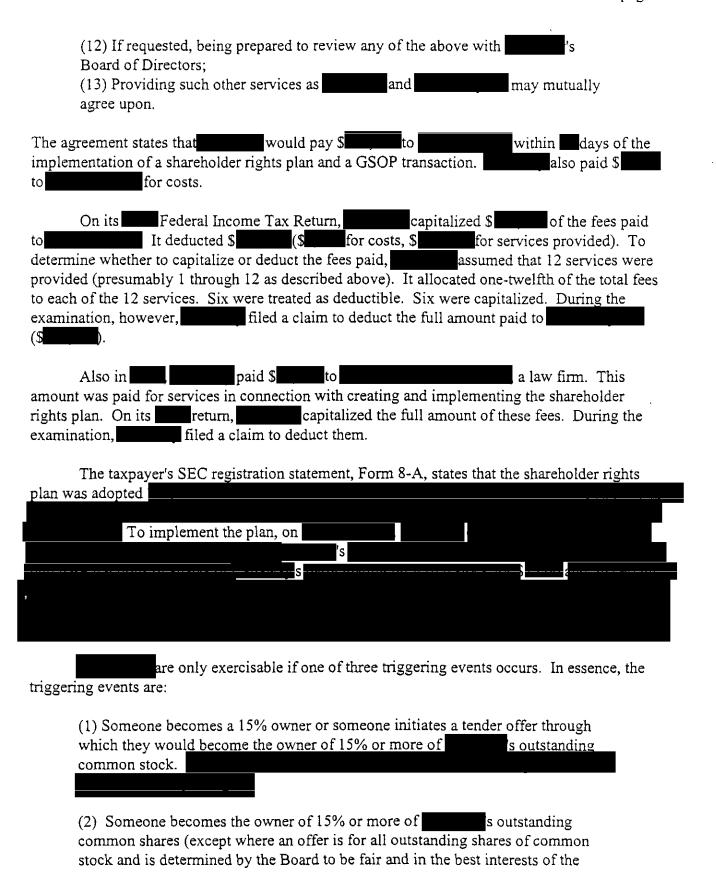
Because the implementation of a shareholder rights plan alters the ownership of the corporation, it is a capital transaction. Expenses incurred in connection with the creation and

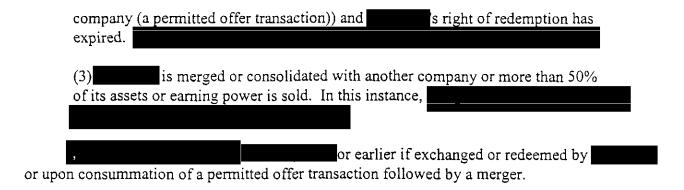
adoption of the plan therefore should be capitalized. It is of no consequence that the plan was adopted for the purpose of defending the corporation from a potential hostile takeover attempt. The remaining expenditures are deductible if shown to be specifically allocable to general advisory and defensive tasks.

# **FACTS**

Our advice is contingent on the accuracy of the information that the Internal Revenue Service has supplied. If any information is uncovered that is inconsistent with the facts recited in this memorandum, you should not rely on this memorandum, and you should seek further advice from this office.

for ag implemer	response to rumors of a possible takeover attempt, during paid financial advice and other assistance to defend against any such attempt.  reed to assist in evaluating and implementing a shareholder rights plan and in ting "employee-based financing transactions" such as an employee benefits stock plan.  n, was hired to assist some some some some some some some some
rig (2) fir (3) (4) pr (5) en (6) sp (7) lir re (8) pr wi op (9) (1) ac (1)	Assisting with the evaluation and implementation of a shareholder this plan;  Updating the Board's familiarity with the business, operations, properties, nancial condition and prospects of the projections for future performance including sensitivity analysis for such projections;  Providing a framework for a financial valuation of and its future pospects;  Advising with respect to publicly available information relating to titles which could be potential acquirers of analyzing sensitivity analysis for such projections;  Analyzing states alternatives of analyzing and effense alternatives including, without intation, a financial analysis of stock repurchases, stock acquisitions and other nated alternatives;  Assisting in analyzing, structuring and effecting a grantor stock ownership orgam (GSOP transaction) or any such similar employee benefits stock plan sich utilizes the seapital stock, including the provision of appropriate inions of legal counsel;  Providing an ongoing review of seapital stock market activity;  Weeping informed about current trends in the merger and quisition arena;  Providing advice and assistance in the event that an unsolicited offer is reatened or initiated;





### DISCUSSION

The taxpayer asserts that all the fees paid to are deductible pursuant to I.R.C. § 162 as ordinary and necessary business expenses.

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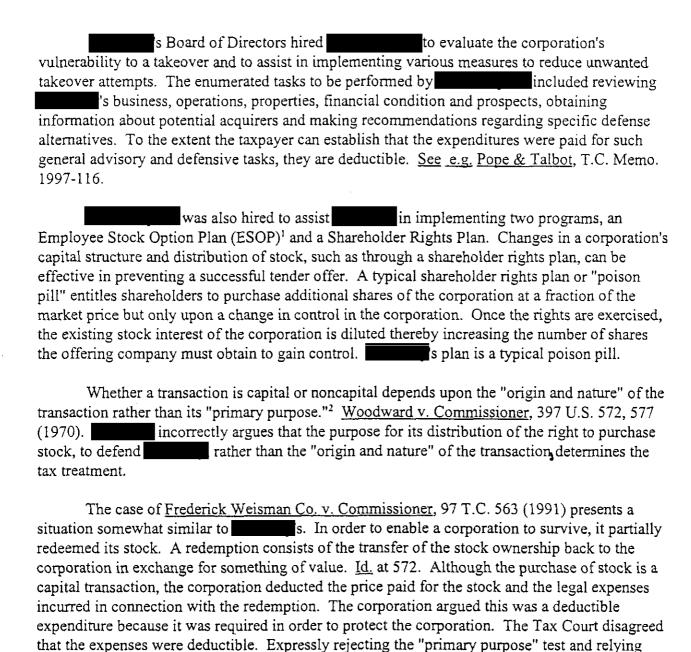
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I.R.C. § 162 allows the deduction of all "ordinary and necessary expenses paid or incurred during the taxable year in carrying on any trade or business." An expense is ordinary even if it rarely occurs or only occurs once within the lifetime of the taxpayer. Welch v. Helvering, 290 U.S. 111,114 (1933). An expense is necessary if it is appropriate or helpful for the development of the taxpayer's business. Id. at 113. Deductions, however, are strictly construed and allowed only when there is a clear provision for them. INDOPCO, Inc. v. Commissioner, 503 U.S. 79, 84 (1992). In general, expenses incurred to defend a business and its policies from attack are ordinary and necessary and deductible business expenses. American Stores Co. v. Commissioner, 114 T.C. No. 27, 18 (2000); A.E. Staley Mfg. Co. v. Commissioner, 119 F.3d 482, 487 (7th Cir. 1997).

In contrast, capital expenditures are not currently deductible. <u>INDOPCO</u>, 503 U.S. at 83. Generally, expenditures are capitalized when they create a separate and distinct asset or when the expenditures provides the taxpayer with a benefit that extends beyond the year in which the expenditure occurred. <u>Id.</u> at 82-83. The "mere presence of an incidental future benefit – 'some future aspect' – may not warrant capitalization," however. <u>Id.</u> at 87.

felt it was vulnerable to a potential hostile takeover. Pursuant to its duty to protect shareholders, so Board of Directors acted to protect the corporation. Defensive measures are appropriate to avoid changes in company policy, prevent a takeover by a looter and to oppose tender offers which are not in the best interest of the shareholders or whose price is inadequate. The measures taken, however, must be reasonable to the perceived threat. Matthew Bender & Company, Inc. Corporate Acquisitions and Mergers, part 3, chapter 5, (2000).



instead on the "origin and nature" of the transaction, it held that the reason for the redemption – to save the corporation – did not transform the transaction into a deductible expenditure. Id. at

<sup>&</sup>lt;sup>1</sup> Since your question did not address the ESOP and did not provide any specific information regarding the ESOP, this memo does not address it. Generally, an ESOP is compensation to employees. As such, expenses associated with an ESOP would be deductible as ordinary and necessary business expenses pursuant to I.R.C. § 162 regardless of whether or not it was implemented as a defensive measure.

<sup>&</sup>lt;sup>2</sup>For further discussion of the "origin and nature" test, please see my last memo to you dated May 11, 2000.

572-73. Further, the Tax Court held that I.R.C. § 311(a)<sup>3</sup> applied to this transaction thereby further preventing the corporation from recognizing a gain or loss. <u>Id.</u> at 574.

Like the redemption in Weisman, s shareholder rights plan is subject to I.R.C.

§ 311(a) because the plan involved the distribution to shareholders of contingent rights to purchase additional stock. This distribution was to shareholders in their capacity as shareholders, not as debtors, creditors or employees. Id. at 567-68. For this reason, as in cannot deduct the amounts paid in connection with implementation of the Weisman. plan. In addition, 's shareholder rights plan caused a change in the ownership of This also makes it a capital transaction. "Stock is most naturally viewed as a capital \ asset." Stark v. Commissioner, T.C. Memo. 1999-1 quoting Arkansas Best Corp. v. Commissioner, 485 U.S. 212, 222-23 (1988). Finally, the shareholder rights plan provides a significant benefit beyond the current year. s expenditures for business advice, planning and legal counsel incurred in connection with the creation and implementation of the plan are also not deductible. See American Stores Co., 114 T.C. at 19. Professional fees incurred in the process of changing the corporate structure for the benefit of future operations are capitalized. INDOPCO, 503 U.S. at 89. s purpose in implementing the plan – to defend the corporation against hostile takeover attempts – is of no consequence. argues that A.E. Staley, 119 F.3d 482 (7th Cir. 1997) and United States v. Federated Dept. Stores, Inc., 171 Bankr. 603 (S.D. Ohio 1994) support its position that expenditures incurred to avoid a hostile takeover attempt are deductible. Those cases, however, did not address the creation of a "poison pill" or the distribution of rights

to acquire stock. Secondly, in those cases a hostile takeover actually took place, thereby

<sup>&</sup>lt;sup>3</sup> I.R.C. § 311(a) states "...no gain or loss shall be recognized to a corporation on the distribution, with respect to its stock, of –

<sup>(1)</sup> its stock (or rights to acquire its stock), or

<sup>(2)</sup> property.

<sup>&</sup>lt;sup>4</sup> The Tax Court in Weisman recognized that I.R.C. § 311(a) applies not only to "gain or loss" but also to the issue of deductibility of costs. <u>Id.</u> at 568, 574.

<sup>&</sup>lt;sup>5</sup> In A.E. Staley, the taxpayer strengthened the terms of its stockholder rights plan by reducing the amount of the ownership that would trigger the "flip in" provision from 40 percent to 20 percent. A presentation discussing this change was made by the corporation's investment banker in March 1987. The change was made on December 14,1987. A.E. Staley, 105 T.C. 166, 171-72 (1995). The return at issue in the case, however, only included the period from to Lid. at 167. Neither the Tax Court opinion nor the Seventh Circuit Court of Appeals opinion discussed the shareholder rights plan. Instead, their opinions addressed the expenses associated with the tender offer which commenced

supporting the conclusion that the expenditures were deductible because no benefit accrued beyond the year in which the defensive expenditures were made. In <u>A.E. Staley</u>, the Court of Appeals also held, however, that the costs incurred in evaluating and investigating a completed capital transaction such as a merger or "other change in corporate structure" must be capitalized despite the hostile takeover. <u>A.E. Staley</u>, 119 F.3d at 491.

If you have any questions, please contact Yvonne M. Peters at (619) 557-6014.

VALERIE K. LIU Associate District Counsel

Bv.

VONNE M. PETERS

Attorney